Ten Magazine

A monetary policy for long-run economic stability

April 02, 2017

The outlook for the economy does not call for tight policy by any means, but a gradual and deliberate move to more normal rates is necessary.

February marked the 92nd consecutive month of the economic expansion in the United States, which is the third-longest U.S. expansion on record going back to about 1850. Since the end of the financial crisis, the economy has grown annually by about 2 percent each year. Unemployment has declined and labor markets appear to have only modest, if any, remaining slack. Inflation has been running at rates consistent with price stability and near the Federal Open Market Committee's (FOMC) longer-run goal of 2 percent. Of course, there are always some areas of concern in the economy, but as a whole, things look fairly positive.

Optimism has increased during the past few months, as measured in both business and consumer surveys. While consumer spending is expected to continue at a healthy pace, this rise in confidence may not automatically lead to even stronger consumer spending. The evidence suggests that consumer confidence is not always a useful predictor of future consumption growth, especially once other factors such as interest rates or income growth are taken into account. Still, household balance sheets are in much better shape compared to the years immediately following the financial crisis and the labor market has been performing well, so the outlook remains positive for consumer spending.

Looking at labor markets, we're essentially at or near full employment. The unemployment rate now sits at 4.8 percent, just below what I view as its longer-run value of about 5 percent. Labor force participation, which had been trending downwards for most of the expansion, has leveled off and even slightly increased over the past year. This recent rise appears to be due to a decline in labor force exits rather than an increase in labor force entry. In other words, individuals are not more likely to return to the labor force right now, but workers are staying on the job longer. These factors suggest that there is not a lot of labor force slack, either among the officially unemployed or those out of the labor force who might rejoin.

Of course, there are numerous indicators on the labor market, so trying to judge the amount of slack is not a straightforward task. One approach we use at the Kansas City Fed is a Labor Market Conditions Index, which was developed by my staff. It summarizes a wide array of labor market data into two succinct statistics: the level of labor market activity and the momentum of that activity. The most recent reading for January showed a level of activity that was above the long-term average, and a momentum indicator that was the highest level since the series began in 1992.

Another important indicator of slack in the labor market is wage growth, which has been quite moderate since the financial crisis, though has increased over the past year. Despite the improvement in overall wage growth, there are differences across sectors. Recent research by my staff shows that the increase in wages has been driven by only a few industry segments—namely, the construction, manufacturing and wholesale sectors. Growth in hours worked in these sectors has been moderating, even as wages rise, perhaps suggesting firms are having an increasingly difficult time attracting new workers. On the other hand, wage growth has shown few signs of acceleration in many of the service sectors, although growth in hours worked has been steadily increasing. This suggests there may have been a modest amount of slack in some service sectors, but as economic growth continues, workers will likely become increasingly scarce. This "bottom up" approach to evaluating the labor market suggests further wage pressure is likely to follow across a broader range of industries.

As labor markets continue to improve and economic activity expands, we could see more inflationary pressure. Currently the FOMC's preferred measure of inflation, the personal consumption expenditures (PCE) price index, has increased by 1.6 percent over the last 12 months. This measure has risen notably, compared to about 0.6 percent a year ago, as the effects of lower oil prices have waned. Looking past these oil price effects, the core measure of inflation is up 1.7 percent over the past year.

Other measures of inflation show similar trends. The Consumer Price Index (CPI) is up 2.5 percent over the past year, the Dallas Fed's trimmed-mean PCE inflation rate over the past year is up 1.9 percent and the Cleveland Fed's weighted median CPI is up 2.5 percent. All these measures point in the same direction: Inflation remains low, but is rising.

The role of monetary policy rules

The current state of the economy stands in sharp contrast to earlier phases of the recovery. Following the crisis, the unemployment rate was persistently above its longer-run normal level and inflation below the FOMC's 2 percent longer-run goal. At the risk of oversimplifying, central banks generally respond with monetary accommodation to support economic activity and achieve their mandated objectives in these conditions. That is, the standard approach is to lower interest rates.

While the policy prescription in such circumstances is generally straightforward, a few complications come into play. The first is that monetary policy operates with lags, which is a point highlighted in the FOMC's annual "Statement on Longer-Run Goals and Monetary Policy Strategy." The timing and extent of any lags are imprecisely measured and can vary over time. Importantly, these lags require monetary policy to act in a forward-looking manner. That is, policymakers cannot wait to take action until they see full employment and inflation at 2 percent. Policy needs to be adjusted in advance. Second, following the crisis, policymakers have become far more attuned to the importance of fostering financial stability. While the relationship between monetary policy and financial stability is not entirely clear, events and research strongly suggest that risk-taking often increases in low-rate environments. Indeed, the motivation for unconventional policies such as large-scale asset purchases was aimed at providing additional stimulus at the zero lower bound by encouraging risk-taking, creating wealth effects and boosting asset prices. And third, policy needs to be set with a sense of the risks surrounding the economic outlook. Foreign developments or financial market volatility are examples of issues that might cause policymakers to temporarily adjust course. Judging the scope and impact of such risks is always challenging, but this caution carries certain costs. Postponing rate adjustments is not unreasonable in the face of near-term risks, but can keep policy stuck in place. The resulting delay can leave a lasting imprint on the stance of monetary policy, especially if adjustments are not made after the risk passes.

Policymakers must deal with such complications. Among the tools available to us are monetary policy rules, commonly known as Taylor rules. These rules provide guidelines for how to calibrate interest rates under most economic conditions. How the FOMC should use such rules has been the focus of some recent public discussion. In fact, the FOMC does consult the guidance coming from monetary policy rules at each of its meetings. Rules come in many flavors, depending on what variables are included, the weights attached to the different variables, and the designated value of the longer-run level of the funds rate. All of these make choosing a single rule difficult, but that's not to say that they are not immensely useful. They may offer different advice, but when all the advice moves in a particular direction, that is usually an important signal to policymakers.

While a variety of rules exist, the intuition behind them is relatively straightforward. Most rules take into account how far inflation is from the FOMC's price stability target, as well as how far the labor market is from full employment. The deviation from their longer-run levels is accounted for in the resulting rate prescription. When both numbers are close to their longer-run levels, these rules often prescribe that the federal funds rate should be near or be moving toward its longer-run level. Indeed, most monetary policy rules today are pointing in the same general direction and suggest short-term interest rates should be moving higher. Given these signals, it may be surprising that the FOMC has only raised its policy rate target twice since the end of the financial crisis.

The path to the longer-run

While these policy rules are prescribing higher short-term interest rates, the FOMC has determined that the path for raising rates will be a gradual one. Part of the reason for a gradual approach is risk management. Moving too quickly could potentially risk slowing economic activity, which obviously would not be an objective of monetary policy given current growth and inflation rates. A more rapid increase in short-term rates also could pose risks to financial stability after an extended period of near zero rates.

While I support this gradual approach, the current readings for inflation and unemployment relative to the FOMC's mandated objectives argue for more than just one move per year, as has been the case over the previous two years. This pace has left the current stance of policy more accommodative than advocated by most policy rules and the funds rate well below its longer-run level, a discrepancy I see as important to remedy in order to preserve longer-run price stability and sustainable growth.

In considering the path to more normal interest rate settings, some have questioned whether monetary policy is truly stimulative given that unusually low rates have not generated the same kind of growth or inflation experienced in the past. One explanation is that certain features of the economy may have changed, and that these changes are reflected in a measure known as the natural rate of interest. For example, short-term interest rates adjusted for inflation—that is, real rates—have been negative for many years. When real rates are low, but the economy is not growing rapidly, the implication is that the natural rate of interest is quite low. Although not observable, movements in the natural rate are presumed to occur gradually, suggesting current low levels will persist and result in a lower longer-run federal funds rate than in the past. The implication of a lower natural interest rate would mean that today's monetary policy settings, although low by historical standards, might not be as stimulative as policy rules suggest.

What would cause the economy to change in such a way? There are likely any number of reasons, but one that seems plausible is that productivity growth has not been as strong as it was in previous decades. Slower productivity growth, which has been an ongoing issue for the economy for some time, means the supply side of the economy also is growing more slowly. As a result, moderate economic growth may be sufficient to absorb slack and could even cause the economy to outrun its potential. In fact, we see this today in some measures of what is called the output gap, which captures the difference between the level of economic activity and what the economy can produce at full employment. For example, the Federal Reserve Bank of San Francisco produces a measure of the output gap and natural rate. They show that 2 percent growth the past few years has actually been higher than the economy's potential and in fact, the amount of economic activity is currently above its potential level. These circumstances often lead to price pressures and higher inflation.

Pulling the pieces together, then, how should monetary policy respond in a setting with a low natural rate of interest and slow productivity growth, but with the economy growing faster than its potential? Again, we can glean insight from Taylor rules, which still would prescribe a higher federal funds rate in the near term to ensure economic activity does not too far exceed its potential capacity, but that rate might top out at a level below what we have seen in the past. That is, the longer-run level of the funds rate could be lower than in previous decades.

The case for a much lower natural rate of interest seems plausible to me, but it puts a great deal of weight on estimates that are subject to considerable uncertainty. History has shown that deviating from long-run variables can increase risk to desired economic outcomes. My own view is that policy must still adjust from its current settings in order to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates" as specified by the Federal Reserve Act.

So while I see a gradual approach to raising rates as appropriate, I see more than one move per year, as has been the case, as needed to achieve the FOMC's objectives.

The challenge of technological change

Economic expansion over the past seven years has brought the labor market and inflation to levels consistent with the FOMC's longer-run objectives. In this environment, policy rules point to higher rates, and there is reason to believe they are fairly signaling. To be sure, the outlook for the economy does not call for tight policy by any means, but a gradual and deliberate move to more normal rates is necessary to limit the risk of creating imbalances and financial stability risks that could surface in undesirable ways.

Editor's Note:

The above text is from remarks George gave Feb. 28, 2017, at Stanford Institute for Economic Policy Research in Stanford, Calif.

Media


SIEPR
STANFORD INSTITUTE FOR
ECONOMIC POLICY RESEARCH
@SIEPR


SIEPR